PROFIT: A MISUSED AND MISUNDERSTOOD TERM

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Many people often confuse, misunderstand, or misuse the term "profit." To some in DOD, the word has a single meaning. To them, profit is a percentage of the manufacturing cost that is passed on to the customer and included in the final agreed-to price that appears in the contract. In other words, profit is what the firm keeps after payment.

Ask those in business for their firm's profit rate and you might get the following response: Do you mean gross or net profit, net income, or increase or decrease in stockholder equity?

Another consideration is the difference between profit margin and profitability. Bear in mind that in the long term, a firm's profitability benefits the Army because it contributes to a stable Defense industrial base. Profit margins are based on total operating revenue and exclude investments in assets or equity investments made by a firm. However, when assessing a firm's profitability, investments in assets or equity investments are included. Besides, assessing a firm's short-term profit margin does not necessarily indicate its long-term financial health or profitability. Over the short term, a firm may forgo a profit margin to achieve a long-term goal. However, a commercial enterprise's long-term financial goal should always be to increase stockholder equity.

The only way to ensure profitability is to obtain returns commensurate with investment risks and use assets prudently; to carefully manage liabilities, stockholder equity, and risk; and to bring the right products to market on time and at the right price.

A firm's profit margins and profitability can be increased in various ways. Some believe that the quickest way to increase profit margin is to sell off fixed assets. The proceeds can be converted immediately into stockholder equity. However, the positive results of this action are short-lived. Without fixed assets, most firms would lose the revenue they require for long-term profitability.

Some believe that a firm's profitability increases when its sales increase. However, increasing sales can involve commensurate or greater increases in liabilities as a firm borrows money to increase its assets to meet increased product demand. Also, investing to increase sales does not guarantee an increase in sales, which further exacerbates a firm's profitability.

Others believe that profitability increases when a product's price increases. In this particular case, net profit margins could increase, but profitability could decrease because the consumer may decide to purchase fewer products. In addition, increasing prices may bring more industry competition and thereby decrease a firm's market share, all of which act to reduce firm's profitability.

The only way to ensure profitability is to obtain returns commensurate with investment risks and use assets prudently; to carefully manage liabilities, stockholder equity, and risk; and to bring the right products to market on time and at the right price. A little luck is also helpful. Competitive industries ensure these types of actions by managers or their businesses will perish. Even monopolistic industries should follow these standards or risk regulation, competition, or both. However, the silent hand of economic forces weakens when controlling a market; in other words, when a market is monopsonistic (a single consumer with multiple sellers), especially if that consumer is the federal government.

Before the federal government pays an excessive profit (which could be defined as a higher price), it needs to assess whether profit returns as defined by industry are reasonable. The government should not just fuel inefficient and ineffective management by the industries from which it purchases products. For example, articles in business journals occasionally describe managers boasting that their firms earn a gross profit margin (GPM) of 25 percent or more. Does the federal government ever pay a firm a 25 percent GPM? Yes, and perhaps routinely. Remember that GPM exists when revenues are greater than cost of goods sold (COGS).

With this understanding of GPM, selling to the government could be a profitable venture. In other words, with the way that the government currently views profit, a firm has the potential to realize an acceptable rate of return on investment, especially when considering the investment risks. Experience has shown that the government routinely allows for general and administrative (G&A) expenses ranging from 5 to 35 percent, a net income/profit of 5 to 15 percent, and facilities capital cost of money (FCCM) between 1 and 5 percent. If each of the given variables is totaled, DOD routinely allows GPM of between 11 and 55 percent. GPM is even greater in cost-type contracts because even though the fee is fixed, the G&A (a major portion of the GPM) and FCCM increase with each increase of COGS. So, if a firm's manager boasts of a 25 percent GPM, could you imagine what investors would think if that same person could boast that his firm earned a GPM of 55 percent? Add the fact that the government will finance its own contracts, and the profitability picture gets even rosier.

The Army must address the following four factors if it does not want to pay an excessive price for the products it purchases and if it expects to help a firm's profitability.

• The Army should not view partnering with the supplier as a panacea to improve its position with its supplier or the industry at large. The reality is that operating in the market is like an economic war. If either the supplier or consumer does not understand the rules of engagement, one of the parties could covertly or accidentally lose a lot of money. Because of its limited view of profit and profitability, the Army is at a serious disadvantage in the marketplace. Parterning does not remedy this situation.

• The Army should not focus on each cost element that makes up the sales price or cringe whenever some firm announces that its annual profit margin is 28 percent. The Army needs to look at COGS and accept an industry standard for GPM. By treating costs this way, the Army leaves the decisions that affect a firm's profitability to the firm's managers and owners. They are the ones most affected by the firm's profitability.

• If these ideas are too radical, at least with cost-type contracts, the Army needs to treat G&A and FCCM the same way the fee is treated: by fixing the GPM. This would provide greater incentive for the contractor to control cost because GPM would not fluctuate with its COGS. Treating G&A and FCCM as part of the fee will leave the contractor in better control to decide its profitability.

• Finally, to maintain or increase a firm's profitability or at least reduce the effects of a firm's inefficient management, the Army must be a good consumer. Good consumers purchase quantities of products that provide for the most efficient use of a firm's assets. Good consumers take possession of the products in the manner agreed to in the contract. Good consumers pay for products on time and in the agreed-to amount. In other words, the Army could improve a firm's profitability by accelerating product acquisition (reducing a firm's ending inventory costs) and paying for those products on time (maintaining or improving a firm's cash flow).

In summary, the Army must realize that the market, even a monopsony, is an economic war between the supplier and consumer. If the Army expects to prevail, it needs to learn the rules of engagement in commercial terms, particularly in terms of profit, profitability, and how these terms relate to the goals of a particular firm and an industry at large. Also, when conducting cost analyses, the Army needs to limit its focus to COGS and establish or accept an industry rate for GPM. This will increase the Army's ability to improve a firm's profitability; increase the Army's market advantage; and enhance the Army's ability to increase its supplier base. Finally, the Army has an easy way to positively influence a firm's profitability: be a good consumer.

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